

## Message Text

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PASS CEA (MALKIEL), TREASURY (VANHORN), FRB (PROMISEL)

E.O.11652: N/A

TAGS: ECON, OECD

SUBJECT: DECEMBER 8 MEETING OF ECONOMIC POLICY COMMITTEE  
(EPC) WORKING PARTY 4: MONETARY ASPECTS OF  
WORLD INFLATION

REFS: (A) CPE/WP4(75)6, (B) CPE//WP4(75)7

1. SUMMARY. WP-4 DISCUSSION OF MONETARY ASPECTS OF  
WORLD INFLATION FOCUSED ON DOMESTIC POLICY ASPECTS OF  
ISSUES RAISED REF A' DEFERRING CONSIDERATION OF INTERNA-  
TIONAL ASPECTS UNTIL LATER TIME. GROUP CAME TO GENERAL  
CONCLUSION THAT MONETARY EXPANSION IN 1971-2 WAS BUT  
ONE OF MANY FACTORS (INCLUDING OIL, FOOD PRICE RISES)  
LEADING TO OUTBURST OF INFLATION IN 1973-4. OUTCOME OF  
DISCUSSION ON SETTING TARGETS FOR GROWTH OF MONETARY  
AGGREGATES WAS ECLECTIC APPROACH THAT IMPORTANCE,  
FEASIBILITY AND EFFECTIVENESS OF MONETARY TARGETS  
DEPERDS ON COUNTRY AND ITS CIRCUMSTANCES, AND THAT ATTEN-  
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TION TO BOTH MONETARY AGGREGATES AND INTEREST RATES IS

USEFUL. GERMANY' U.S. AND CANADA PLACED MOST STRESS ON VIRTUES OF TARGETS FOR GROWTH OF MONETARY AGGREGATES, BUT MAJORITY OF COUNTRIES FELT THAT THIS APPROACH EITHER NOT FEASIBLE OR NOT ONE ON WHICH MAJOR RELIANCE COULD BE PLACED. WP-4 CHAIRMAN (COUZENS) REPORTED TO WP-4 PLENARY ON MAJOR TECHNICAL AND POLICY CONCLUSIONS REACHED AT DECEMBER 5-6 MEETING OF MONETARY EXPERTS GROUP. THESE CONCLUSIONS WERE ALONG SAME LINES AS THOSE REACHED IN PLENARY. BRIEF DISCUSSION OF 1976 COST AND PRICE PROSPECTS (REF B) REFLECTED GENERALIZED ASSESSMENT THAT DURING ECONOMIC UPTURN CYCLICAL PRODUCTIVITY INCREASES WOULD DIMINISH IMPACT ON COSTS OF NOMINAL WAGE INCREASES AND WOULD ALLOW FIRMS TO EXPAND PROFIT MARGINS WITHOUT LARGE PRICE INCREASES. SECRETARIAT WILL SUBMIT WRITTEN REPORT TO EPC ON RESULTS OF MEETING; DRAFT OF THIS REPORT WILL BE CIRCULATED TO DELEGATIONS FOR COMMENTS IN EARLY JANUARY. //WORK PROGRAM FOR TWO MEETINGS AHEAD WAS APPROVED, WITH NEXT MEETING TENTATIVELY SET FOR MAY (SEE PARA 13).

2. MONETARY EXPANSION AND INFLATION: COUNTRIES ASSIGNED VARYING WEIGHTS TO MONETARY CAUSES OF RECENT INFLATION, WITH U.S. DEL (MALKIEL) ASSERTING THAT IN U.S. CASE MONETARY EXPANSION PLAYED RELATIVELY MINOR ROLE, AND WITH SMALLER COUNTRIES STATING THAT FOR THEM EXTERNALLY INFLUENCED MONETARY FACTORS WERE RELATIVELY MORE IMPORTANT THAN FOR THE LARGER COUNTRIES (ALTHOUGH, FOR MOST SMALL COUNTRIES, NOT MORE IMPORTANT THAN OTHER EXTERNAL FACTORS SUCH AS OIL, FOOD, AND COMMODITY PRICE INCREASES). COUNTRIES FELT THAT ON BALANCE MONETARY POLICY PLAYED AN ACCOMMODATING RATHER THAN AN INITIATING ROLE IN 1973-4 INFLATION. INITIATING ROLE ASSIGNED INSTEAD OF EXOGENOUS SHOCKS AND SYNCHRONIZED EXPANSION IN GENERAL.

3. U.S. ARGUED THAT MONETARY EXPANSION IN 1971-2 WAS

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ONLY ONE CAUSE OF 1973-4 INFLATION AND THAT FOR THE U.S. OTHER FACTORS, SUCH AS INCREASES IN FOOD AND OIL PRICES, INVENTORY SPECULATION, DOLLAR DEVALUATION, AND EXCESS AGGREGATE DEMAND OVERALL, WERE MORE IMPORTANT, U.S. REASONED THAT AVERAGE ANNUAL RATE OF EFFECTIVE MONETARY GROWTH (M1 PLUS TREND VELOCITY INCREASE) WAS 9 PERCENT, AND THAT CAPACITY OUTPUT WAS GROWING BY 4 PERCENT; THUS IT WOULD BE DIFFICULT TO EXPLAIN INFLATION RATE OF MORE THAN 5 PERCENT ON MONETARY GROUNDS. IN ADDITION, U.S. FELT THAT MONETARY EXPANSION ACCOMMODATED EXOGENOUS INFLATIONARY SHOCK RATHER THAN ITSELF INITIATING INFLATIONARY PROCESS. ESSENCE OF POLICY DILEMMA AS SEEN BY U.S. IS THAT MONETARY ACCOMMODATION OF EXOGENOUS SHOCKS PERPETRATES INFLATION, BUT FAILURE TO DO SO RESULTS IN CONTRACTION OF REAL MONEY SUPPLY AND RISING UNEMPLOYMENT WHICH CAN LEAD TO EXCESSIVE MONETARY EXPANSION TO REVERSE RECESSIONARY SITUATION.

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4. FRG (MOLITOR AND BUCH) NOTED THAT FLOATING OF DM HAD LED TO RELATIVE MONETARY INDEPENDENCE, AND HAS REMOVED MONETARY EXCESS AS MAJOR INFLATIONARY ELEMENT. OTHER LARGE COUNTRIES (U.K., JAPAN, CANADA) EMPHASIZED COMBINED INFLATIONARY EFFECTS OF EXPANSIONARY MONETARY AND FISCAL POLICIES, WITH CANADA LEANING TOWARD MONETARY EXPLANATIONS AND U.K. TOWARD FISCAL, AND WITH BOTH COUNTRIES UNDERSCORING COST-PUSH INFLUENCE OF WAGE PRESSURE. NO LARGE COUNTRIES SINGLED OUT MONETARY EASE AS MOST IMPORTANT CAUSE OF INFLATION. SOME NOTED MONE-

TARY EASE COULD HAVE HAD PREDOMINANT INFLUENCE IN SPECIFIC MARKETS SUCH AS REAL ESTATE AND MAY HAVE FACILITATED INVENTORY SPECULATION, THEREBY HELPING TO DRIVE UP COMMODITY PRICES.

5. ON BALANCE, THE SMALLER COUNTRIES (SWITZERLAND, AUSTRIA, NETHERLANDS, IRELAND, DENMARK) ATTRIBUTED RELATIVELY MORE WEIGHT TO MONETARY CAUSED OF INFLATION AND FELT THIS WAS PARTIALLY DUE TO DIFFICULTY OF INSULATING THEIR ECONOMIES FROM INTERNATIONAL MONETARY DEVELOPMENTS. HOWEVER, MOST SMALL COUNTRIES ALSO POINTED TO RISING OIL, COMMODITY AND FOOD PRICES AS IMPORTANT INFLATIONARY CULPRITS, AND TENDED TO LAY MOST OF THE BLAME ON THESE FACTORS.

6. MONETARY TARGETS: U.S. LED OFF DISCUSSION OF MONETARY TARGETS BY MAKING STRONG CASE FOR ADOPTION OF TARGET FOR GROWTH OF MONETARY AGGREGATES. EMPHASIZING THAT LARGE DISCRETIONARY SWINGS IN POLICY WITH THEIR LAGGED EFFECTS HAD BEEN MAJOR FACTORS UNDERLYING ECONOMIC INSTABILITY AND INFLATION, U.S. ARGUED THAT ADHERENCE TO MONETARY NORMS WOULD ELIMINATE ONE IMPORTANT SOURCE OF INSTABILITY AND WOULD CONTRIBUTE TO REDUCING INFLATION RATE. FURTHERMORE, PUBLISHING SUCH NORMS WOULD HAVE FAVORABLE EFFECT ON PRICE EXPECTATIONS, CONTRIBUTING TO LOWER INFLATION RATES AND TO MORE STABLE INTEREST RATES.

7. FRG AND CANADA SUPPORTED U.S. ADVOCACY OF PUBLISHED TARGETS FOR MONETARY AGGREGATES. FRG EMPHASIZED THAT LIMITED OFFICIAL USE

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PUBLISHED TARGETS PROVIDED STRONG SIGNAL TO LABOR AND BUSINESS THAT EXCESSIVE WAGE AND PRICE INCREASES WOULD NOT BE ACCOMMODATED BY AUTHORITIES AND THUS WOULD LEAD ONLY TO FALLING OUTPUT AND UNEMPLOYMENT. CANADIANS REASONED THAT ADOPTION OF MONETARY TARGETS IS A "SECOND BEST" SOLUTION, SINCE IN ABSENCE OF KNOWLEDGE OF SPECIFIC EFFECTS OF MONETARY POLICY ON REAL VARIABLES, SAFEST OPTION IS THAT OF STABILITY. THEY ADDED THAT PREREQUISITE WAS STABILITY OF VELOCITY AND THAT EMPIRICAL EVIDENCE INDICATED EXISTENCE OF SUCH STABILITY IN U.S., CANADA AND FRG.

8. FRANCE AND U.K. QUESTIONED FEASIBILITY AND DESIRABILITY OF SETTING TARGETS, AND PARTICULARLY OF PUBLISHED TARGETS. FRANCE (BARRE) STRESSED DIFFICULTY OF FINDING A TARGET WHICH WAS OPERATIONALLY VALID, AND ADDED THAT POORLY DEVELOPED CAPITAL MARKETS (THE FRENCH CASE) WOULD MAKE CONTROL OF ANY AGGREGATE DIFFICULT.

U.K. ECHOED FRENCH VIEWS. THEY NOTED THAT VELOCITY WAS PROBABLY UNSTABLE IN U.K., THAT ADHERENCE TO MONETARY TARGETS WOULD THEREFORE BE DESTABILIZING, AND THAT PUBLISHED TARGETS, PARTICULARLY INTEREST RATE TARGETS, COULD ACTUALLY MAKE ACHIEVEMENT OF THOSE TARGETS AND HENCE OF MONETARY POLICY OBJECTIVES MORE DIFFICULT.

9. SMALL COUNTRIES COMMENTED THAT THEIR MONETARY

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INDEPENDENCE WAS NOT SUFFICIENT TO MAKE SETTING TARGETS FEASIBLE. MOREOVER, IF TARGETS WERE PUBLISHED, INABILITY TO ACHIEVE THEM WOULD DAMAGE GOVERNMENT CREDIBILITY. ITALIANS (SUPPORTED BY SMALLS) FELT THAT APPROPRIATENESS OF SETTING TARGETS DEPENDED LARGELY ON STABILITY OF PRIVATE (INCLUDING EXTERNAL) SECTOR. IN COUNTRIES WHERE DOMESTIC PRIVATE SECTOR IS UNSTABLE OR IN COUNTRIES WHICH ARE RELATIVELY MORE OPEN AND VULNERABLE TO EXTERNAL SHOCK, STABLE GROWTH OF MONETARY AGGREGATES COULD BE DESTABILIZING.

10. OVERALL CONCLUSION OF WP-2 CHAIRMAN WAS THAT ADHERANCE TO

TARGETS FOR GROWTH OF MONETARY AGGREGATES WAS PERHAPS FEASIBLE AND DESIRABLE FOR FRG,U.S., AND POSSIBLY FOR CANADA, AND THAT POLICY STABILITY IN THESE MAJOR COUNTRIES WOULD HAVE MAJOR STABILIZING EFFECT ON OTHER COUNTRIES WITH MORE OPEN, LESS INDEPENDENT ECONOMIES. (DANES WERE STRONGEST ADVOCATE OF THIS VIEW.) FURTHERMORE, WP-4 FELT THAT REDUCTION OF INFLATION RATE REQUIRED NOT JUST AN APPROPRIATE MONETARY POLICY, BUT CONSISTENT SET OF MUTUALLY SUPPORTIVE MONETARY, FISCAL AND IN SOME LIMITED OFFICIAL USE

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SOME INCOMES POLICIES. CHOICE OF LEADING EDGE OF POLICY SHOULD DEPEND ON INSTITUTIONAL ENVIRONMENT AND ON PRIME SOURCES OF INFLATIONARY PRESSURES. CONTRASTING EXAMPLES WOULD BE FRG, WHERE PRESTIGE OF BUNDESBANK AND MODERATE WAGE PRESSURES ALLOW MONETARY POLICY TO BE "OUT-FRONT" IN SUPPORT OF INFORMAL WAGE NEGOTIATIONS, AND U.K. WHICH, BECAUSE OF STRONG WAGE PRESSURES, EMPHASIZES INCOME POLICY AND PLACES SUPPORTIVE MONETARY POLICY IN BACKGROUND.

11. COST AND PRICE OUTLOOK: MAJOR COUNTRIES EXCEPT BETTER PRICE PERFORMANCE IN 1976 THAN IN 1975. U.S. STATED THAT 1976 WOULD BE STRONG BARGAINING YEAR, WITH STRONG UNIONS BATTING FIRST (TEAMSTERS, ELECTRICIANS, RUBBER WORKERS), AND THAT AVERAGE INCREASE IN COMPENSATION PER MAN-HOUR COULD BE 9.5 PERCENT. HOWEVER, BECAUSE OF CYCLICAL PRODUCTIVITY INCREASE, UNIT LABOR COST ONLY EXPECTED TO RISE BY ABOUT 5 PERCENT, WITH HIGHER RATES EXPECTED TO RISE BY ABOUT 5 PERCENT, WITH HIGHER RATES OF CAPACITY UTILIZATION ALLOWING EXPANSION OF PROFIT MARGIN WITHOUT EXCESSIVE INCREASES IN MANUFACTURING PRICES. MOREOVER, FOOD AND OIL PRICE OUTLOOK SHOULD CONTRIBUTE TO HOLDING INFLATION RATE TO 6 PERCENT IN 1976.

12. U.K. FELT THAT 6 POUND WAGE LIMIT WOULD STICK AT LEAST UNTIL AUGUST 1976, AND THAT INFLATION RATE WOULD COME DOWN TO 10 PERCENT. CANADIANS SAW ANTI-INFLATION PROGRAM BRING NEXT YEAR'S INFLATION RATE DOWN TO 10 PERCENT, WHILE JAPAN AND FRANCE EXPECT PRICE INCREASES OF 10 PERCENT AND 8 PERCENT RESPECTIVELY IN 1976, COMPARED TO 1975 INCREASES OF 12 PERCENT AND 11 PERCENT PREDICTED IN 1975. THESE COUNTRIES (AND SMALLER COUNTRIES) AGREED WITH U.S. VIEW THAT PRODUCTIVITY INCREASES AND HIGHER RATES OF CAPACITY UTILIZATION IN 1976 WOULD ALLOW FIRMS TO EXPAND PROFIT MARGINS WITHOUT EXCESSIVE PRICE INCREASES. NONETHELESS, WORKING PARTY FELT THAT BALANCE OF RISK IN 1976 PRICE FORECASTS COULD BE ON UPSIDE, SINCE EXPANSION

IN OECD AREA COULD EXERT RENEWED PRESSURE ON COMMODITY  
PRICES.

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13. FUTURE WORK PROGRAM: WP-4 APPROVED WORK PROGRAM FOR  
NEXT TWO MEETINGS TENTATIVELY SET FOR MAY AND DECEMBER  
1976. MAY MEETING WILL CONCENTRATE ON THOROUGH REVIEW  
OF INFLATION PROSPECTS AND APPROPRIATE POLICY RESPONSES  
12 MONTHS INTO UPSWING. WORKING PARTY CHAIRMAN SUGGESTED  
THAT DOCUMENTATION FOR MAY MEETING BE LEFT UP TO THE  
SECRETARIAT AND THE DOCUMENTS BE DISTRIBUTED AS COM-  
PLETED RATHER THAN JUST PRIOR TO MEETING . AT DECEMBER  
MEETING DISCUSSION OF DEMAND MANAGEMENT POLICY AND  
INSTRUMENTS WILL CONTINUE AND WILL BE BROADENED TO  
INCLUDE FISCAL POLICY. WORKING PARTY WILL ANALYZE  
LAGS IN IMPLEMENTATION AND ECONOMIC IMPACT OF MONETARY  
AND FISCAL POLICY, AND WILL ASSES THEIR RELATIVE  
EFFICACY IN DAMPENING CYCLICAL FLUCTUATIONS IN THE SHORT-  
RUN AND IN REDUCING THE RATE OF INFLATION OVER THE  
MEDIUM TERM  
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